The Economic Potential of Foreign Trade Zones (FTZs) in Canada

The Issue and Opportunity

In order to understand the importance of a Foreign Trade Zone (FTZ) one has to look to the US for clarity on their process.

The U.S. Customs and Border Patrol (CBP) designate FTZs as locations that, for purpose of customs duty payment, are outside its jurisdiction. What this means is until imported goods actually enter territory within CBP's jurisdiction, companies need not pay duty.

Should Canada provide for this instead of providing limited tax and duty-relief programs, this provision could reap economic benefits for Canadian retailers and manufacturers, particularly those companies that opt to produce goods in foreign locations and then bring them back to Canada for repackaging, finishing or distribution. FTZ status allows these corporations to import the items, apply whatever intermediate processes it desires and then export them without incurring duty.

Sometimes, these secondary processes can even result in a new Harmonized Tariff Schedule (HTS) code that confers a lower duty rate when the goods do become subject to duty payment.

Likewise, companies can defer duty payments on imported goods by warehousing items in an FTZ until more favorable market conditions prevail. Any goods imported into an FTZ can be transferred, duty free, to other FTZs, whether they are located in Canada, United States, or Mexico. While stored, some goods may even be exempt from inventory taxes levied by state and local authorities. Further, FTZ status can translate to reduced customs clearance and service fees.

Compliance Comment

To leverage the economic benefits of an FTZ, importers must first obtain FTZ status from Canadian Border Services and then institute procedures to ensure compliance with CBS's detailed regulations governing FTZ operations. The key concern is controlling inventory and creating audit trails of goods movement in, out, and within zones, subzones, and business sites. Otherwise, any financial benefits will be lost to focused assessments, fines and penalties.

While the regulations governing FTZs are quite detailed, software is available that automates all aspects of compliance; creates, generates, submits and maintains an audit trail of all the required paperwork; and updates compliance requirements in real time via an electronic interface with CBS. Acquisition adds a one-time expense for software purchase and integration.

Why Would a Company Use a FTZ?

All of the benefits the Foreign-Trade Zones program can offer manufacturers and processors located in Canada are too numerous to list within this policy statement; however, there a few main benefits that account for most of the companies that use the Zones program. Those benefits are listed below:

- **Relief from inverted tariffs** — In certain instances, there are tariff (import duty) relationships that actually penalize companies for making their product in Canada. This occurs when a component item or raw material carries a higher duty rate than the finished product. Hence, the importer of the finished product pays a lower duty rate than a manufacturer of the same

product in Canada. This gives the importer an unfair and unintended advantage over the domestic manufacturer. The Foreign-Trade Zones program levels the playing field in these circumstances.

- **Duty exemption on re-exports** — Without a zone, if a manufacturer or processor imports a component or raw material into Canada, it is required to pay the import tax (duty) at the time the component or raw material enters the country. However, a Foreign-Trade Zone is considered to be outside the commerce of Canada and Canada Border Services territory. So, when foreign merchandise is brought into a Foreign-Trade Zone, no Customs duty is owed until the merchandise leaves the zone and enters the commerce of Canada. Only then is the merchandise considered imported and the duty paid. If the imported merchandise is exported back out of the country, no Customs duty is ever due.

- **Duty elimination on waste, scrap, and yield loss** — Without a zone, an importer pays the Customs duty owed as material is brought into Canada. This is because the material is considered imported at this point. If the processor or manufacturer is conducting its operations within a zone environment, the merchandise is not considered imported, and therefore no duty is owed until it leaves the zone for shipment into Canada. To demonstrate how this would benefit a company that has scrap, waste, or yield loss from an imported component, an example of a chemical processing plant (using hypothetical chemicals) provides more clarity on the concept:

  FOR EXAMPLE*: A chemical plant manufacturing hydroxywidgitpropolyne, which carries a 15% duty rate, uses the raw material oxyovertaxophene, which also carries a 15% duty rate, for one of its raw materials. Part of the production process consists of bringing the imported oxyovertaxophene to extreme temperatures. During this process 30% of the oxyovertaxophene is lost as heat. If a processing company not in the Zones program imports $10,000,000 per year of oxyovertaxophene, it will pay $1,500,000 in duty as the raw material enters Canada*.

  If the same company utilizes the FTZ program, it does not pay duty on the oxyovertaxophene until it leaves the zone and is imported into Canada. The zone user brings the oxyovertaxophene into the zone with no duty owed. It then processes the oxyovertaxophene into hydroxywidgitpropolyne. Remember, during this process 30% of the raw material is lost due to waste factors, so the $10,000,000 in oxyovertaxophene is now worth only $7,000,000. Assuming all of the end product is sold into Canada, the 15% Customs duty totals only $1,050,000. This represents a savings of $450,000.

  While at first glance it might look like the Zones program is simply benefiting an importer, it is important to remember that its competitors making the same product overseas already have the benefit of not having to pay on the yield loss in the production of their hydroxywidgitpropolyne.

- **Weekly Entry Savings** — The Canadian Government can mirror the US Trade and Development Act of 2000 to capitalize on weekly entry procedure for all manufacturing and distribution Foreign-Trade Zones. What this means is:

  Weekly Entry (allowed only to Foreign-Trade Zone users) provides economies for both Customs and Foreign-Trade Zone users. Under Weekly Entry procedures, the zone user files only one Customs Entry per week, rather than filing one Customs Entry per shipment. Customs no longer has to process an entry for each and every shipment being imported into the zone, and the Foreign-Trade Zone community no longer has to pay for the processing of each and every entry.

Companies located outside Foreign-Trade Zones pay a .21% merchandise processing for each and every formal entry processed by Canada Border Services. In the USA, a minimum $25 processing and a maximum $485 processing fee per Entry, regardless of the duty rate on the imported merchandise is charged. The maximum processing fee is reached for Entries (shipments) with a value over $230,952. Companies often receive many shipments over this amount. ***Using these amounts the following example is advanced:***

FOR EXAMPLE: *10 shipments per week, each with a value of over $230,952, would amount to a merchandise processing fee of $4,850 ($485 x 10) per week. If this number is annualized the amount is $252,200 (52 x $4,850) per year.*

Companies in a Foreign-Trade Zone may take advantage of the Weekly Entry procedure. In the case of the above example, Weekly Entry would provide for one Entry per week. For example: the 10 ($230,952) shipments per week would be filed as a single shipment of $2,309,520 each week. The merchandise processing fee would amount to the maximum of $485 total for the week. If this fee is annualized utilizing Weekly Entry it is a total of only $25,220 yearly. In this example Weekly Entry provides a savings of $226,980 per year. Each company's savings could be significantly more or less depending on the number of shipments received during the year.

- **Duty Deferral**—Again, since Foreign-Trade Zones are outside the Customs territory of Canada, goods are not imported until they leave the zone. Therefore, Customs duty is deferred until merchandise is imported from a Foreign-Trade Zone into Canada. So, instead of companies having substantial monies tied up in Customs duties on their inventory, they have use of that money for other purposes, which are good for business.

There are many other substantial benefits that the Zones program has to offer manufacturers and distributors in the United States, but the benefits listed are the key benefits that attract most companies to the Zones program. More and more companies look globally when deciding to locate or expand a new manufacturing or processing facility. When these companies make these location and expansion decisions, they do take into account all costs of manufacturing in a certain country. Unfortunately, there are unintended import tax penalties for many companies located in, or considering locating in, the United States. The Foreign-Trade Zones program plays an important role in providing a level playing field when investment and production decisions are made. While the U.S. government might incur a reduction in Customs duty revenue by the use of the Zones program, it more than makes up for it by the income tax it gains from the jobs created or retained. In addition, local governments benefit from sales and property taxes.

The Foreign-Trade Zones program has proven to be a successful trade program by consistently creating and retaining jobs and capital investment in the United States.

Canada's FTZ Program

Canada does not have a FTZ program per se. To emulate a US FTZ requires packaging of several Canadian programs, depending on the nature of the planned activity. Programs could include the Duty Deferral Program (DDP), comprised of Customs Bonded Warehouse, Sufferance Warehouse, Duty Relief and/or Duty Drawback, the Exporter of Processing Services (EOPS) Program and the Export Distribution Centre (EDC) Program. This complexity makes Canadian FTZs harder to market, though market leaders are striving to streamline the process.

THE EDC program was intended to address the tax issue and complement the existing duties programs. However, even a full combination of Canadian programs does not provide all the options US FTZs offer.

The EDC program limits the amount of value-added activity that can take place and prohibits activities that substantially alter the product. Only duties can be relieved if substantial alteration takes place – not taxes. EOPS provides tax relief for substantial alteration, but can only be used if the processor never takes ownership of the goods and is not related to the non-resident for whom the processing is done.

The following shortcomings of Canadian FTZ approach have been identified:

- the lack of an "operators certificate" which would enable smaller firms to access an established FTZ without having to go through the registration process themselves;
- severe limitations on the nature and magnitude of value-added activity that is permitted;
- restrictions on eligibility of participating firms;
- the complexity of existing programs; and
- the lack of a single window concept to streamline access to programs.

Current Canadian FTZs

Despite the current limitations, FTZs are marketed in several Canadian communities. CentrePort Canada is a prime example. CentrePort has developed a single window approach that simplifies the process for those interested in FTZ operations. While CentrePort has been successful in attracting economic activity to its site, the successes to date do not included FTZ-like activity. Gander International Airport Authority has been marketing FTZ capabilities for several years, but has not yet managed to secure FTZ-like activity that continues to occur in the north-east US.

The Goal - what could FTZs mean for Canada?

The Government of British Columbia recently released a report which examined the feasibility of a BC FTZ program. While it is difficult to project what economic activity a FTZ could generate since there is no "typical" FTZ and not all FTZs are successful, it projected economic impact for high, medium and low scenarios. A Vancouver-based FTZ could employ between 2,200 and 5,300 people directly, with a GDP impact of between $140 million and $340 million. Adding indirect and induced impacts results in between 3,500 and 8,600 jobs and between $170 and $415 million in GDP. It anticipated FTZ activity in other BC communities as well, albeit at lower levels of activity. The study also found that the taxes generated by the additional activity would more than offset the interest the government would earn from holding the prepaid duties and taxes from remittance to refund under the current system.

FTZs could benefit any location in Canada where a business case exists for value-added activity.

Getting there – what changes are needed?

Key steps to achieve this goal:

- The federal government should develop a new FTZ program. It needs to be flexible enough to allow any amount of value-added processing, including manufacturing, and should be broadly available to firms. The program should be simple to apply to, with single window access covering all aspects. The program needs to be a modern one, with FTZs not tied to specific geographic locations, and should use modern accounting systems for control rather than physical means such as fences and guards.

- The federal government should actively market the program, including trade mission support, rather than simply make it available.